CHAPTER 15

OTHER SPECIFIC SUBSIDIES

The Treasury Department proposals would repeal various business subsidies contained in the Code, including the rehabilitation tax credit, the merchant marine capital construction fund provisions, the possession tax credit, and special rules for book, magazine, and discount coupon income. The research and experimentation credit would be retained, but modified to improve its efficiency.

REPEAL TAX CREDIT FOR QUALIFIED REHABILITATION

General Explanation

Chapter 15.01

Current Law

A special investment tax credit (the "rehabilitation credit") is provided for qualified expenditures incurred in connection with the rehabilitation (but not enlargement) of certain old or historic buildings. The credit rate is equal to (a) 15 percent for qualified expenditures incurred in connection with buildings at least 30 years old but less than 40 years old, (b) 20 percent for qualified expenditures incurred in connection with buildings at least 40 years old, and (c) 25 percent for qualified expenditures incurred in connection with certified historic structures of any age. The regular investment tax credit and the energy investment tax credit do not apply to any portion of an expenditure which qualifies for the rehabilitation credit.

The rehabilitation credit is limited to expenditures incurred in connection with buildings that will not be used for lodging (except in the case of certified historic structures), and is available only if the taxpayer elects to use the straight-line recovery method with respect to the expenditures. A rehabilitation must be substantial to qualify for the credit. In general, this requirement is met if rehabilitation expenditures incurred over a 24-month period exceed the adjusted basis of the property at the beginning of that period. In addition, at least 75 percent of the building's external walls must be retained in place.

The 25 percent credit for rehabilitations of certified historic structures is subject to certain additional requirements. In general, the 25 percent credit is not available unless the rehabilitation is certified by the Secretary of the Interior as being consistent with the historic character of the building or the district in which the building is located. Certified historic structures include only (a) buildings listed in the National Register and (b) buildings located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district.

In the case of a qualified rehabilitation of a certified historic structure, the basis of the rehabilitated building is reduced by 50 percent of the amount of the credit. The reduction is 100 percent of the credit in the case of other qualified rehabilitations. If a rehabilitation credit is subsequently recaptured, corrective basis adjustments are made (and treated as occurring immediately before the recapture event).

Reasons For Change

As enacted in 1962, the investment tax credit was unavailable for buildings and their structural components. In limiting the credit to tangible personal property, Congress was primarily concerned about the greater average age and lower efficiency of domestic machinery and equipment in comparison with the facilities of major foreign producers.

In 1978, Congress noted a decline in the usefulness of existing, older buildings, primarily in central cities and older neighborhoods, and extended the regular investment tax credit to older buildings for the purpose of promoting stability and economic vitality in deteriorating areas. No special credit was provided for certified historic structures, although the credit was made available for rehabilitation of such structures only if the Secretary of the Interior certified the rehabilitation as appropriate.

In 1981, Congress enacted the Accelerated Cost Recovery System (ACRS), and noted that ACRS had the unintended effect of reducing the relative attractiveness of the original (ten percent) credit for rehabilitating older buildings. Accordingly, Congress replaced the original rehabilitation credit with the three-tier credit contained in current law. The three-tier system had the effect of (1) increasing the amount of the credit available for all qualified buildings, (2) further increasing the credit for buildings more than 30 years old, and (3) providing a special increased credit for certified historic structures.

The current rehabilitation tax credit is flawed in several respects. First, the credits are embedded in a complicated matrix of tax rules which, taken as a whole, result in widely varying after-tax returns for investments in different types of assets. There is no evidence that the combined tax benefits granted to rehabilitators of older buildings, when compared to the tax benefits available to constructors or rehabilitators of newer buildings, are an appropriate incentive for investment in older buildings. Moreover, since the amount of the credit for any qualified rehabilitation is generally a function only of (1) the age of the existing structure, and (2) the cost of the rehabilitation, the incentive effects of the credit are not limited to investment in deteriorating areas, as opposed to modernization of older structures in stable areas.

In addition, the 25 percent credit for certified historic structures is effectively administered by an agency without budgetary responsibility for the revenue cost. The Secretary of the Interior is given sole authority to determine whether a structure meets the requirements for the credit, but the subsidy is not included in the Interior Department's budget. Thus, in determining the availability of the credit, the sole reviewing agency has no direct incentive to compare probable costs and benefits.

Proposal

The rehabilitation credit would be repealed.

Effective Date

Repeal would be effective for expenditures incurred on or after January 1, 1986. An exception would be provided for expenditures incurred pursuant to binding commitments entered into prior to the introduction of this proposal in legislation. Expenditures incurred, other than pursuant to binding commitments, after the effective date would be aggregated with expenditures incurred prior to the effective date for purposes of determining whether the earlier expenditures were incurred in connection with a "substantial" rehabilitation.

Analysis

In the absence of investment tax credits for rehabilitation expenditures, the full amount of such expenditures would be recovered through normal cost recovery rules. Under a system of economic depreciation, effective tax rates on investment in rehabilitation of older and historic structures would be comparable to effective tax rates on other investments.

REPEAL SPECIAL RULES FOR BOOK, MAGAZINE, AND DISCOUNT COUPON INCOME

General Explanation

Chapter 15.02

Current Law

Magazine, Paperback, and Record Returns. An accrual basis taxpayer that distributes magazines, paperbacks, or sound recordings for resale may elect (irrevocably) to exclude from gross income for the taxable year certain amounts attributable to the sale of such items if the purchaser fails to resell the items and returns them within a specified period after the end of the taxable year (2-1/2 months in the case of magazines, and 4-1/2 months in the case of paperbacks and recordings). The exclusion applies only if, at the time of sale, the taxpayer has a legal obligation to adjust the sales price if the items are not resold, and the exclusion is limited to the amount of price reductions for returns that are actually made within the prescribed periods.

An election to take advantage of this exclusion triggers the application of special transitional adjustment rules designed to prevent the "bunching" of deductions in the first year of the election. In the case of an election relating to magazines, the decrease in income resulting from the bunching of deductions in the first year is spread over a five-year period. In the case of an election relating to paperbacks or records, however, the decrease is placed in a suspense account. Adjustments to this suspense account permit additional exclusions from income in subsequent taxable years only to the extent the taxpayer's adjustments from post-year returns decline over time. In general, the effect of the suspense account is to defer deduction of the transitional adjustment until the taxpayer ceases to be engaged in the trade or business of publishing or distributing paperbacks or records.

Redemptions of Qualified Discount Coupons. An accrual basis taxpayer that issues discount coupons with respect to merchandise marketed by unrelated retailers may irrevocably elect to deduct in the taxable year the cost of redeeming qualified coupons that are returned within six months after the end of the taxable year. A shorter period may be used at the taxpayer's election.

In the case of an election under this provision, the decrease in income resulting from the "bunching" of deductions in the first year is not allowed but is placed in a suspense account. Adjustments to this suspense account permit additional deductions in subsequent taxable years only to the extent the taxpayer's qualified discount coupon redemptions decline over time. If such redemptions do not decline, the suspended amounts may be deducted only when the taxpayer ceases to be engaged in the business.

EXTEND AND MODIFY RESEARCH AND EXPERIMENTATION CREDIT

General Explanation

Chapter 15.03

Current Law

A 25 percent nonrefundable tax credit is allowed for the portion of a taxpayer's qualified research expenses which is equal to the lesser of (1) the excess of such expenses in the current year over the average amount of such expenses for the prior three years or (2) 50 percent of qualified research expenses in the current year. Special rules apply to aggregate qualified research expenses of certain related persons to ensure that the credit is available only for real increases in qualified research expenditures.

"Qualified research expenses" generally include only research and development costs in the experimental or laboratory sense. Qualified research expenses that are eligible for the credit include (1) expenses paid or incurred for qualified research conducted directly by the taxpayer, (2) 65 percent of any amounts paid or incurred to another person for qualified research (i.e., "contract research" expenses), and (3) in the case of corporate taxpayers, 65 percent of any amounts contributed to universities and other qualifying organizations for the conduct of basic research.

The credit is available only for research expenses paid or incurred in connection with an ongoing trade or business of the taxpayer. Employee wages are treated as qualified research expenses to the extent paid to an employee for engaging in (1) the actual conduct of qualified research, (2) the immediate supervision of qualified research activities, or (3) the direct support of such activities. Payments for supplies used in the conduct of qualified research and amounts paid for the right to use personal property in the conduct of qualified research also constitute qualified research expenses.

Expenses of (1) research conducted outside the United States, (2) research in the social sciences and humanities, and (3) funded research are specifically excluded from qualified research expenses eligible for the credit.

Credits that are not used in a taxable year may be carried back three years and forward 15 years. The credit will not be available for expenses paid or incurred after December 31, 1985.

Reasons For Change

The existing credit for research and experimentation activities is intended to create an incentive for technological innovation. The benefit to the country from such innovation is unquestioned, and there

Reasons for Change

The primary purpose of the special provisions for magazine, paperback, and record returns, and redemptions of qualified discount coupons, was to enable taxpayers to conform their tax accounting to their financial accounting. In both cases, the exclusion or deduction is designed to approximate decreases in adjusted gross income that would have accrued at the end of the taxable year if the amount of the taxpayer's price-adjustment or redemption obligation were known at that time.

On the other hand, there is a general standard for accrual of liabilities in the taxable year -- occurrence of all events sufficient to establish the existence and amount of the liability. The cases covered by the current rules do not satisfy this standard, since the events establishing the taxpayer's liability for the adjustment -- return of magazines, paperbacks, or records, or presentment of coupons -- have not occurred as of the end of the year.

Both provisions lead to a mismatching of income and deductions and an understatement of total income in the economy. Redemptions of discount coupons in year two are deducted by the issuer in year one even though the retailer may not include the redemptions in income until year two. Similarly, refunds for returns of magazines, paperbacks, and records are deducted in year one by the publisher even though the retailer may not include the refunds in income until year two. The mismatching results in a one-year deferral of taxation of the income, a deferral that increases annually in the case of new and growing firms.

Repeal of these rules would also simplify the tax code and would make it unnecessary to determine the correctness of taxpayers' claims that post-year price adjustments and redemptions are made pursuant to obligations or coupons that were outstanding prior to the end of the taxable year.

Proposal

The elections (a) to exclude from income certain adjustments relating to magazines, paperbacks, and record returns, and (b) to deduct costs of redeeming qualified discount coupons, would be repealed.

Effective Date

The repeal would be effective for taxable years ending on or after January 1, 1986. Affected taxpayers would be permitted to deduct the balances of their suspense accounts or suspended amounts in the first taxable year in which the proposal is effective.

Analysis

Taxpayers adversely affected by repeal of these special accounting rules would gain a compensating benefit from the proposed general reductions in tax rates.

are reasonable grounds for believing that market rewards to those who take the risks of research and experimentation are not sufficient to support an optimal level of such activity. The credit is intended to reward those engaged in research and experimentation of unproven technologies.

Although the credit for research and experimentation is justified in concept, the existing definition of eligible activities is overly broad. Some taxpayers take the view that the costs of any trial and error procedure are eligible for the credit even though there may be little doubt about the outcome of the procedure.

The definition of qualifying expenses for purposes of the credit should identify clearly those innovative research activities which merit government support. This definition also should incorporate standards that are sufficiently objective to permit taxpayers, in planning their activities, to determine with reasonable certainty whether the credit will be available. A definition that satisfies these two criteria would be more effective in encouraging taxpayers to undertake innovative research and experimental activities.

Proposal

The credit for increases in research and experimentation expenditures would be extended for an additional three years (until December 31, 1988), and the definition of qualified research would be revised to target those research activities likely to result in technological innovations.

Effective Date

The revised definition of qualified research would be effective for expenses paid or incurred after December 31, 1985.

Analysis

The definition of expenses qualifying for the research credit should target private research activities designed to lead to technological innovations in products and production processes. At the same time, the definition must be phrased in terms that permit taxpayers to know with reasonable certainty what research activities qualify for the credit.

A useful definition incorporating both principles is found in the Senate amendment to H.R. 4170 (enacted as the "Tax Reform Act of 1984"). Although the conference committee agreed to defer consideration of the research credit, the Senate definition targets technological innovation and provides taxpayers with relatively objective rules.

The Senate definition focuses on new or technologically improved products and processes and provides that research qualifies for the credit only if it relates to a process of experimentation encompassing

the evaluation of alternatives that involve a serious degree of uncertainty as to whether the desired result can be achieved. This requirement is designed to ensure that the credit is available only for research activities intended to lead to technological innovation. In addition, the Senate definition excludes a number of activities, such as reverse engineering and debugging, that, by their nature, will not result in technological innovation.

Further refinements in the Senate definition, such as identifying additional exclusions from the scope of qualifying research, may be appropriate to ensure that the credit does not subsidize private research activities that are not innovative. In addition, the revenue loss resulting from the extension of the credit must be considered in redefining the scope of qualifying expenses.

Finally, the proposal to extend the research credit does not include support for other proposals traditionally associated with the credit, such as a separate credit for contributions to fund basic university research or an enhanced charitable deduction for contributions of scientific equipment to universities.

REPEAL MERCHANT MARINE CAPITAL CONSTRUCTION FUND EXCLUSION

General Explanation

Chapter 15.04

Current Law

The Merchant Marine Act provides special tax treatment for U.S. citizens and domestic corporations owning or leasing certain eligible vessels operated in the foreign or domestic commerce of the United States or in U.S. fisheries. A vessel qualifies as an eligible vessel only if it was constructed or reconstructed in the United States and is documented under the laws of the United States.

In general, a taxpayer that qualifies for this treatment receives a deduction for amounts deposited in a capital construction fund pursuant to an agreement with the Secretary of Transportation or, in the case of U.S. fisheries, the Secretary of Commerce. The deductible amount is limited to the portion of the taxable income of the owner or lessee that is attributable to the qualified operation of the vessel covered by the agreement. In addition, nondeductible deposits may be made up to the amount of depreciation on such vessel for the year. Earnings on all amounts in the fund are exempt from federal income tax liability.

The tax consequences of a withdrawal from such a fund are determined by reference to three accounts. The capital account represents deposits that were not deductible as well as the fund's tax-exempt income (that is, income exempt from tax without regard to the fund's special exemption). The capital gain account represents accumulated net long-term capital gain income of the fund. The ordinary income account represents deductible deposits and accumulated taxable income of the fund (that is, income that would have been taxable if the fund were not exempt).

The tax treatment of a withdrawal depends on whether it is "qualified." A withdrawal is qualified if used to acquire, construct, or reconstruct eligible vessels (or barges and containers which are part of the complement of such vessels) in accordance with the terms of the applicable agreement, or to repay principal on debt incurred with respect to such acquisition, construction, or reconstruction.

A qualified withdrawal is not currently taxable, and is deemed to come first out of the capital account, then out of the capital gain account, and finally out of the ordinary income account (after the other accounts have been exhausted). Amounts withdrawn from the ordinary income or capital gain accounts reduce the taxpayer's basis in its investment in the vessels (only in part in the case of capital gain account withdrawals). A taxpayer may, however, compute its

investment tax credit by including at least one-half of its qualified withdrawals in basis. Accordingly, the taxpayer is entitled to at least a partial investment tax credit on investments made with fund withdrawals, even though its basis attributable to withdrawals is zero for purposes of computing depreciation. A qualified withdrawal out of the ordinary income or capital gain account made to retire debt requires a reduction in the basis of vessels, barges, and containers owned by the person maintaining the fund.

Nonqualified withdrawals are deemed to come first out of the ordinary income account, then out of the capital gain account, and finally out of the capital account. A nonqualified withdrawal treated as made out of the ordinary income account must be included in taxable income. To the extent the withdrawal comes out of the capital gain account it is taxed as long-term capital gain; a withdrawal out of the capital account is not taxable. Interest on the tax liability attributable to the withdrawal is payable from the time for payment of tax for the year in which the item was deposited into the fund.

Reasons for Change

The current rules for taxation of merchant marine capital construction funds are a gross departure from generally applicable principles of taxation. The special rules generally exempt from tax earnings on deposits in such funds. Moreover, they permit an eligible taxpayer to expense capital investments made with fund withdrawals as well as claim an investment tax credit on an asset in which it has a zero basis.

The special tax treatment of capital construction funds originated, along with a direct appropriations program, to assure an adequate supply of shipping in the event of war. It was thus feared that because of comparative shipbuilding and operating cost disadvantages, peacetime demand for U.S.-flag vessels would not reflect possible wartime needs.

A national security justification for subsidies of U.S. maritime construction is today very much in doubt. U.S. citizens own or control large numbers of ships registered in Panama, Liberia, and Honduras that would be available to the United States in an emergency, and most U.S. allies possess substantial fleets of oceangoing cargo ships that would be available in any common emergency. Largely for this reason, direct appropriations for maritime construction (the construction differential and operating differential subsidies) are being phased out. A similar fate is appropriate for the special tax rules applicable to capital construction funds.

Proposal

The rules providing special tax treatment for capital construction funds would be repealed.

Effective Date

Earnings on assets in capital construction funds attributable to the period after January 1, 1986, would be subject to tax. No further tax-free contributions could be made after the date legislation is introduced. Any withdrawals from a fund after January 1, 1986, would be treated as nonqualified withdrawals, but would be treated as coming first out of the capital account, then the capital gain account, and finally the ordinary income account. Any amounts remaining in a capital construction fund on January 1, 1996, would be treated as withdrawn at that time.

Analysis

Repeal of the special tax treatment for capital construction funds would promote neutrality by ensuring that capital investments are made only when justified by economic rather than tax considerations.

REPEAL POSSESSIONS TAX CREDIT

General Explanation

Chapter 15.05

Current Law

Section 936 provides a special credit for certain income of qualifying corporations operating in Puerto Rico and possessions of the United States other than the Virgin Islands. A section 936 corporation is generally subject to tax on its worldwide income in a manner similar to any other U.S. corporation, but a full credit is given for the U.S. tax on the business and qualified investment income from the possessions regardless of whether any tax is paid to the government of the possessions. The effect of this treatment is to exempt from tax the income from business activities and qualified investments in the possessions and the income from disposition of a possessions business. (Rules having similar effect, but through a different mechanism, for the Virgin Islands are contained in section 934(b)). All other income of section 936 corporations is taxed currently with the usual credit for foreign taxes paid on foreign source income. To avoid a double credit against U.S. taxes, no credit is allowed under section 901 for taxes paid on income subject to the section 936 credit, and no deduction is allowed for such tax.

Any domestic corporation which elects to be a section 936 corporation can receive the section 936 credit if it satisfies two conditions. First, 80 percent or more of its gross income for the three year period immediately preceding the close of the taxable year must be from sources within a possession (or possessions). Second, for tax years beginning after 1984 at least 65 percent of its income for that period must be from the active conduct of a trade or business within a possession (or possessions).

Puerto Rico has complemented the section 936 credit with incentives of its own. Puerto Rico grants tax exemptions of up to 90 percent for income of certain approved enterprises for specified periods of time (generally 10 to 25 years). In addition, Puerto Rico exempts from tax certain passive income. The combination of the section 936 credit and the Puerto Rican incentives means that qualifying corporations are essentially exempt from tax on their Puerto Rico source income.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) made two changes designed to reduce the revenue cost due to (a) the attempted allocation of intangible income to possessions in order to claim exemption for such income, and (b) the exemption of passive income. The problem of intangible income was addressed by adding a very complex set of allocation rules to section 936 for tax years

beginning after 1982. The revenue cost of exempting passive income was addressed by increasing the active trade or business percentage from 50 percent in 1982 to 65 percent in 1985.

The income tax systems in effect in the U.S. territories basically mirror the Internal Revenue Code but with special exceptions and provisions that vary from one territory to another.

Reasons for Change

Independently of the section 936 credit, a corporation can generally achieve indefinite deferral of U.S. tax on possessions business source income, under the rules applicable to the income of foreign corporations, simply by incorporating in a possession. The section 936 credit produces an additional benefit in the form of a negative effective tax rate on possessions source income. This is accomplished by providing income allocation rules which, in many cases, permit shifting income from the U.S. parent to a section 936 corporation. This distorts investment decisions without necessarily transferring real economic activity to the possessions.

The stated purpose of section 936 is to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations". Despite the fact that the inflation-corrected tax-exempt income of possessions corporations has more than doubled since 1972, employment levels (both overall and in the manufacturing sector) have been flat. The average tax benefit per employee for all section 936 corporations was more than $22,000 in 1982. In that year the average wage of possessions corporations' employees was $14,210. Fourteen corporations received tax benefits in excess of $100,000 per employee.

The TEFRA changes were designed to reduce the revenue cost of this program. There remains, however, no direct incentive under current law to increase employment in the possessions. As a result, we have a system which is one of the most complex in the tax law, expensive, difficult to administer and yet has not been effective in creating jobs in the possessions.

The territorial tax systems are replete with inconsistencies and ambiguities which have made it difficult to coordinate the Federal and territorial income taxes, and make them susceptible to abuse. They also result in unequal tax burdens on comparable incomes in the different territories.

Proposal

The Treasury Department does not believe that there should be a permanent tax subsidy for operations in the possessions. As noted above, the general rules for taxation of foreign corporations provide for deferral of U.S. tax on the income of such corporations until the income is repatriated. However, it is important to minimize the disruption caused by changes in the tax law. Therefore, the current

system will be replaced with a more cost-effective approach which would then be phased out after several years.

The current section 936 credit will be replaced by a wage credit. The amount of the credit will be a fixed dollar amount per hour worked. The credit will be available for all persons employed in the possessions by an establishment engaged in manufacturing. The credit will not be refundable but may be carried to any other taxable year in the period 1987-2000. The deduction for wages will be reduced by the amount of the credit. A similar change will be made for corporations receiving the benefits of section 934(b).

The wage credit will replace the existing credit for taxable years beginning on or after January 1, 1987. It will be 60 percent of the minimum wage for a six year period, 1987 through 1992 and then will be phased out in equal installments over the next six years:

Year	Credit as percent of minimum wage
1987-1992	60
1993	50
1994	40
1995	30
1996	20
1997	10
1998 and subsequent	0

The territorial income tax systems will be rationalized to make them simpler and fairer and to reduce the potential for abuse.

Analysis

The current system is complex, expensive and ineffective. The rules for determining possessions source income are among the most complex in the tax law. The average revenue cost per job was more than 150 percent of the average total compensation of employees of section 936 corporations. Despite this, total employment has been flat. The proposal will simplify the law considerably and will provide a more direct and more cost-effective incentive to create jobs in the possessions.

Since the tax benefits received by some current section 936 corporations will be substantially reduced under a wage credit, these corporations, primarily in the pharmaceutical and electronics industries, may decide to restructure or even close their operations in the possessions. However, the proposal should attract more labor intensive industries.